

| <b>Contents</b>   | <b>Page</b> |
|---|-------------|
| Using offshore entities and financial arrangements to evade taxes | 2           |
| California's NEST penalty   | 3           |
| FTB acts quickly on feedback from stakeholders                    | 3           |
| New adjusted interest rate  | 4           |
| 2008 Federal and state e-services workshops                       | 5           |
| California Tax Policy Conference coming in November               | 5           |
| Electronic payment options and advantages                         | 6           |
| Inside FTB  | 7           |
| • State tax relief for California wildfire victims                | 7           |
| • Tax information for same-sex married couples                    | 7           |
| • New online service for lien payoff demand requests              | 8           |
| Criminal Corner   | 8           |

## Using offshore entities and financial arrangements to evade taxes

We are accustomed to tax agencies warning taxpayers against using offshore financial arrangements to avoid tax obligations. There are, however, a number of legitimate business and personal reasons for California taxpayers to create entities and financial arrangements offshore. For example, in some foreign countries a United States company can only conduct business by creating a corporation in that country. Other reasons for creating entities and other financial arrangements offshore include:

- Simpler regulatory frameworks.
- Proximity to major economies or to countries attracting capital inflows.
- A way to pool financial resources and knowledge among participants from more than one country.

We find, however, that entities and other financial arrangements are not always created offshore for lawful reasons. Most tax haven countries have little or no government oversight and have strict secrecy laws against disclosures of business and banking records. This combination can encourage offshore banks, attorneys, trustees, and other service providers to falsify, fabricate, or fail to provide records. Tax haven countries often promote the creation of entities and other financial arrangements as a means to:

- Divert untaxed income and conceal assets for taxpayers who have no real operations in a foreign country.
- Evade tax or launder money.
- Take advantage of higher levels of anonymity to escape the notice of taxing agencies in the taxpayer's home country.
- Prevent creditors and lawyers from placing liens or seizing bank records and accounts in tax haven jurisdictions.
- Generate unsubstantiated expenses.

An example of one of these arrangements is the creation of an offshore company that generates unsubstantiated expenses for personal services that have not been performed by, but are reported by, a California corporation. Another example involves hiding income or passing it through a multitude of entities, to avoid reporting it as California income.

FTB is committed to the fair administration of California's income tax laws, and reducing California's tax gap, to prevent those who break the law from gaining an unfair competitive advantage. If you know of taxpayers who engage in these types of unlawful arrangements:

- Fax the information to: 916.843.2060.
- Write to: Franchise Tax Board, PO Box 1565, Rancho Cordova, CA 95741.

Get more information on California income and franchise taxes by visiting our website [ftb.ca.gov](http://ftb.ca.gov).

## California's NEST penalty

California's noneconomic substance transaction understatement penalty, commonly referred to as the NEST penalty, imposes a 20 percent penalty for understatements attributable to noneconomic substance transactions (Revenue and Taxation Code (R&TC) Section 19774). The penalty increases to 40 percent for transactions that are not adequately disclosed.

A transaction lacks economic substance either because: (1) it lacks an economic benefit or, (2) there is no bona fide, non-tax California business purpose for entering into the transaction.

In cases where your client has received a final federal audit report, we may assess the NEST penalty in lieu of the accuracy-related penalty assessed on the audit report if both of these criteria are met:

- The federal adjustment was from a transaction lacking economic substance.
- Tax benefits from this same transaction were reported on the California tax return.

Unlike California, the Internal Revenue Service does not have a NEST penalty.

This penalty is imposed on a Notice of Proposed Assessment. To dispute the NEST penalty, your client should file a protest of the penalty within the required 60-day time period (R&TC Section 19041), and also file a Request for Chief Counsel To Relieve Penalties (form FTB 626).

The factors relating to whether the penalty was properly imposed will be developed during the protest process. The Chief Counsel relief process (R&TC Section 19774(d)) is the mechanism for determining whether to withdraw or reduce the NEST penalty. The Chief Counsel's determination will consider all grounds raised in the dispute of the penalty including substantive arguments concerning economic substance and business purpose.

The Chief Counsel will issue a determination on the Request for Penalty Relief. Your client cannot appeal or challenge the Chief Counsel's refusal to compromise the penalty before the State Board of Equalization or in court. A Notice of Action will be issued on the remaining issues which are the subject of the protest.

Your client may also contest the penalty after paying the full amount and filing a claim for refund with FTB, and may appeal to the State Board of Equalization or file an action in court after the refund claim is denied or deemed denied.

---

## FTB acts quickly on feedback from stakeholders

We received valuable feedback from stakeholders at two separate meetings held in July and August 2008, and have taken action accordingly.

## Changes to the Tax Practitioner Hotline

At the annual Executive Officer's Advisory Board meeting on July 22, 2008, members of the tax professional community offered advice, asked questions, and heard program presentations. Among other issues, practitioners discussed the FTB Tax Practitioner Hotline. They reported

that their calls to the Hotline often resulted in a busy signal, followed by disconnection. They have had to redial several times to get through to the Hotline.

Here's what we've done to correct this situation:

- We redirected staff from within the same bureau to assist with Hotline calls and correspondence.
- Between August 1 and August 11, 2008, we increased the capacity of the call-waiting queue from 12 to 30 calls. This 150 percent increase in queue depth will reduce the number of calls that are disconnected after getting a busy signal. More tax practitioners can wait on hold to talk with one of our Hotline customer services representatives, without getting disconnected.

To avoid waiting, we encourage potential callers to take advantage of the self-service opportunities on our website [ftb.ca.gov](http://ftb.ca.gov). For personal income tax accounts, find "Online Services" to the left on our home page, click on "My FTB Account" and follow the procedures to access your client's account. The website is available around the clock, and you will view the same information our staff sees.

### **Decision made: California Schedule M-3 postponed**

FTB held an Interested Parties meeting on August 11, 2008, to discuss our proposed California Schedule M-3 (*Net Income (Loss) Reconciliation*) for Corporations, S Corporations, Limited Liability Companies, and certain partnerships. (See [August 2008 Tax News](#) for the article [FTB is developing a California Schedule M-3](#).)

Based on comments we received at this meeting we will not be issuing a 2008 California Schedule M-3. We will continue working on this schedule for the 2009 tax year, and will conduct another Interested Party Meeting in November 2008 to continue the discussion with tax professionals.

---

### **New adjusted interest rate**

The adjusted interest rate has been determined for the period January 1, 2009, to June 30, 2009. On January 1, 2009, the rate will drop to 5 percent from the current rate of 7 percent.

The interest rate (Section 19521, formerly 19269, of the Revenue and Taxation Code) is compounded daily, and accrues for personal income, corporate income, and franchise taxes.

The rate for corporation tax overpayments for the period will also drop on January 1, 2009, from 3 percent to 2 percent.

You can find current and former [adjusted interest rates](#) on our website [ftb.ca.gov](http://ftb.ca.gov) (search for current interest rate).

---

## 2008 Federal and state e-services workshops

Once again, we are teaming with the Employment Development Department (EDD), Board of Equalization (BOE), and the Internal Revenue Service (IRS) to sponsor free, annual e-services workshops. Beginning September 3, and running through October, we will bring you the latest information on our e-programs and services.

Attend a workshop to:

- Get the latest updates on individual and business e-file programs.
- Get Information on how e-services can benefit you and your business.
- Get help enrolling in e-file and e-service programs.
- Talk directly to e-service representatives from FTB, IRS, EDD, and BOE.
- "Test-drive" the latest software.
- Earn State and Federal Continuing Professional Education (CPE) credits.

Hurry and secure your spot by registering online. Go to our website at [ftb.ca.gov](http://ftb.ca.gov) and search for free e-services workshops.

---

## California Tax Policy Conference coming in November

The State Bar of California Taxation Section, with FTB and the State Board of Equalization (BOE) present the 2008 Annual Meeting of the California Tax Bar and California Tax Policy Conference.

On November 6-8, your colleagues will convene in San Francisco at the Grand Hyatt to attend the premier California tax event.

This year's conference features 12 state and local tax programs. The timely topics that will be discussed in the interactive programs include:

- Allocation and apportionment.
- Coast-to-coast litigation advancements.
- High-technology industry issues.
- New BOE rules for tax appeals.
- California settlement cases.
- Regulatory and administrative developments.
- Nationwide sales and use tax updates.
- California's taxation of trusts.

The conference also gives you the opportunity to earn up to 14.5 education credits. See the [conference flyer](#) for a complete listing and description of the state tax programs being held at this year's event.

## Electronic payment options and advantages

Third quarter estimated tax payments are due Monday, September 15. We encourage you to tell your clients about two easy ways they can make their payments electronically. By paying electronically, they won't have to spend time writing and mailing checks, or wonder if we received their checks on time, because electronic payments are quickly applied to taxpayers' accounts.

### Web Pay

Your clients can access our free online program at any time to schedule a payment up to one year in advance. To use Web Pay, your clients simply enter the payment amount and the date they want the funds to be transferred from their checking or savings account. A built-in verification process for bank account and routing numbers helps taxpayers avoid entering incorrect banking information.

Personal income taxpayers can also use Web Pay to pay any FTB liability, including:

- An estimated tax (Form 540-ES).
- A balance due on their tax return.
- An extension (Form FTB 3519).
- A prior-year balance.
- A bill.

To find out more, go to our website [ftb.ca.gov](http://ftb.ca.gov) and search for Web Pay.

### Credit Card

Your clients can use their credit cards to pay any bill when they make a payment through Official Payments Corporation. Official Payments Corporation charges a convenience fee of 2.5 percent (minimum \$1), and accepts the following cards:

- Discover/NOVUS
- MasterCard
- Visa
- American Express

To make a payment, your clients can either call 800.2.PAY.TAX (800.272.9829) or go to [officialpayments.com](http://officialpayments.com).

In this tough economy, we want to work with you and your clients to meet their tax liabilities. If your clients are unable to pay their balances in full, let them know they can apply for an installment agreement online. Generally, your clients will qualify if they:

- Owe a balance of \$10,000 or less.
- Agree to pay their balance in 36 months or less.
- Have filed all personal income tax returns.

We also accept installment agreement applications for balances up to \$25,000, and for payment periods up to 60 months. If you have clients who owe balances between \$10,000 and \$25,000, they need to call us at 800.689.4776 to discuss setting up an installment agreement.

---

## Inside FTB

### State tax relief for California wildfire victims

California taxpayers affected by the recent California wildfires are eligible for special tax relief.

Taxpayers affected by the wildfires can claim a disaster loss in either the current tax year or the prior year. Claiming the loss in 2007 will allow FTB to quickly issue a refund to the affected taxpayer.

The personal income tax relief is available in counties that have had federal emergency disaster declarations. Counties declared a disaster area to date include: Butte, Kern, Mariposa, Mendocino, Monterey, Plumas, Santa Barbara, Santa Clara, Santa Cruz, Shasta, and Trinity Counties.

If you have clients claiming the disaster loss, write "California Wildfires 2008" in red ink at the top of the tax return to alert FTB to expedite the refund.<sup>1</sup> Taxpayers can get FTB's amended 2007 tax return or original 2007 tax return at FTB's website at [ftb.ca.gov](http://ftb.ca.gov).

Your clients who need copies of lost or damaged state returns should complete Form FTB 3516, Request for Copy of Tax Return. Disaster victims can receive **free** copies of tax returns. Print "California Wildfires 2008" in red at the top of the request.

We will regularly post updated tax information relating to the fires on our website.

Taxpayers who have questions about their accounts can call FTB toll-free at 800.852.5711 Monday through Friday from 7 a.m. to 6 p.m.

### Tax information for same-sex married couples

The California Supreme Court recently invalidated two segments of the Family Code that prevented same-sex couples from getting married. The Court ruled that same-sex couples were allowed to marry beginning June 16, 2008, at 5:00 p.m. (see FTB Notice 2008-5).

We established a new web page to answer your questions about this ruling, and its effect on the tax laws. The California same-sex married couples (SSMCs) web page presents:

- Information about the California Supreme Court's decision on SSMCs.
- The main SSMC tax issues and frequently asked questions. This includes information on income withholding, estimated tax payments, filing status requirements, etc.

---

<sup>1</sup> Taxpayers who e-file should follow their software instructions to enter the disaster information.

- A draft copy of *Tax Information for Same-Sex Married Couples* (FTB Pub. 776) that is available for review and comment.

Bookmark the SSMC webpage to check for updated FAQs, important news, and other information. You can also sign up to receive updates on SSMCs through FTB's subscription services. Go to ftb.ca.gov and search for subscription services.

### **New online service for lien payoff demand requests**

We recently introduced e-Demand, an online application that makes it easier for escrow, title, or mortgage companies to submit lien payoff demand requests. The e-Demand application is a fast and easy way to submit demand requests to us for individuals or business entities. Up to ten e-Demand requests can be submitted in a single session.

To access e-Demand, go to ftb.ca.gov and enter e-Demand in the search field. From this webpage you can also link to other lien information sources. For answers to your questions about this new service, please call 916.845.7086.

---

### **Criminal Corner**

We are committed to closing California's \$6.5 billion tax gap, defined as the difference between tax that is owed, and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These behaviors include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. You can report suspected tax fraud by calling FTB at **800.540.3453**.

### **Leland Wong convicted of 14 felony counts including 3 felony state income tax counts**

On July 25, 2008, former Los Angeles City Commissioner Leland Wong was convicted of 14 felony counts including 3 felony counts of state income tax fraud.

A jury convicted Wong, 51, of:

- One count of bribery (Penal Code 68).
- One count of perjury (Penal Code 118).
- Two counts of conflict of interest (Government Code 1090 ).
- Three counts of filing fraudulent state income tax returns (Revenue and Taxation Code Section 19705(a)).
- Seven counts of grand theft (Penal Code 487(a)).

According to court documents, Wong received bribes totaling \$100,000. Wong failed to claim any of this illegal money, and was convicted of two counts on his 2002 state income tax return

and one count on his 2003 state income tax return. All income is taxable, including income from illegal sources.

Wong's sentencing is scheduled for September 25, 2008. Restitution to FTB of more than \$6,000 representing the unpaid tax, penalties, interest, and the cost of the investigation will also be ordered at that time.

### **Stockton dentists face state income tax charges**

A married couple, both dentists, was arraigned on four felony counts of state income tax evasion.

Regis A. M. Atienza, Jr., 48, and Annabelle L. Atienza, 47, of Stockton, were self-employed during the years 2002 - 2005. According to FTB special agents, the Atienzas' sole proprietorship allegedly earned gross receipts of \$1.5 million during these years, resulting in taxable income of \$477,374. For these same years, the Atienzas failed to file their state income tax returns reporting this income. After FTB agents requested an interview with the Atienzas in October 2007, the delinquent returns were filed in May 2008. However, the Atienzas have yet to pay nearly \$72,000 in taxes, penalties, interest, and the cost of the investigation.

Each tax count carries a maximum sentence of one year in state prison and a fine of up to \$20,000 in addition to the restitution to the state.

### **Mission Viejo pair plead guilty to state income tax evasion**

On August 1, 2008, a Mission Viejo man and woman pleaded guilty to three felony counts of failing to file state income tax returns and one felony count of making false statements.

Anthony E. Brennan, 52, and Carla Ann Brennan, 60, operated Brennan & Sons Painting as an independent subcontractor to other general contractors. The couple, now divorced, received compensation of more than \$1 million during the years 1999 to 2001 and failed to file state income tax returns for these same years.

The court ordered FTB full restitution of \$187,071 representing the unpaid tax, penalties, interest, and the cost of the investigation. The Brennans previously paid \$100,000 of the restitution amount and are being allowed time to pay the remainder. Additionally, Anthony and Carla were each given 40 hours of community service and placed on formal probation for five years.

FTB discovered this case through its internal procedures. Each year FTB reviews income records from numerous sources, including the Internal Revenue Service, the California Employment Development Department, the Board of Equalization, employers, and banks. FTB compares this data with its database of tax returns filed to identify individuals who should have filed taxes but did not, or to find discrepancies between the income reported and income claimed. Annually, FTB contacts 800,000 individuals who have failed to file a California state income tax return.

**Long Beach woman sentenced to prison for embezzlement, state income tax fraud**

A Long Beach woman was sentenced on August 1, 2008, to four years in state prison on one felony count of grand theft, and one felony count of filing a false state income tax return.

Patricia A. Cruz, 46, pleaded guilty to the charges on July 3. According to court documents, Cruz was employed as a secretary for a local commercial construction firm. She abused her position of trust by writing fraudulent checks from the corporate bank account for her personal gain. Between 2003 and 2007, Cruz embezzled more than \$500,000 from her former employer before the company owner discovered the theft. When confronted, Cruz admitted to the theft and then presented a spreadsheet detailing the amount and extent of her theft. Cruz used the stolen funds to purchase personal items.

In addition, Cruz failed to claim the embezzled funds on her 2004 - 2006 state income tax return. All income is taxable including income from illegal sources.

Cruz was also ordered to pay restitution of \$572,672 to her former employer and \$89,520 to FTB representing the unpaid tax, penalties, and interest.

**Woodland Hills tax preparer arrested for preparing fraudulent state income tax returns**

On August 11, 2008, special agents from the State Controller's Office and FTB arrested a Woodland Hills man on 4 felony counts of filing fraudulent state income tax returns, 58 felony counts of causing fraudulent state income tax refunds to be issued, 1 felony count of grand theft, and 1 felony count of identity theft.

Roland G. Uy, 64, is a self-employed tax preparer. According to FTB special agents, Uy allegedly operated a refund fraud scheme to generate increased tax refunds for his clients. Uy filed both single and head of household state income tax returns on behalf of his married clients and falsely inflated the amounts of their child and dependent care credits. These actions fraudulently inflated the amount of each taxpayer's state income tax refund. Uy is also charged with identify theft for falsely using the identities of two individuals as daycare providers for the clients' children. These individuals never provided any daycare services for any of the children listed on the tax returns. Uy generated increased fees for his tax preparation services by billing his clients for two tax returns rather than the properly filed single or married filing joint return. The loss to the state is more than \$527,000.

If convicted of all charges, Uy faces up to 20 years in state prison as well as being ordered to pay restitution to FTB of the fraudulent tax refunds plus the cost of the investigation. The case was discovered by FTB's internal fraud detection program.

This was a joint investigation between the State Controller's Office and FTB. Each year FTB receives more than 15 million income tax returns and the State Controller's Office issues more than 5 million paper refund warrants.

**Santa Ana courier firm owner guilty of income tax and unemployment tax fraud**

The owner of a Santa Ana based courier firm pleaded guilty to five felony counts of state income tax fraud, five misdemeanor counts of failure to withhold state income tax, and one felony count of workers' compensation fraud.

Evell Stanley, 66, is the owner and operator of Orange Courier, Inc., a messenger and delivery company. According to court documents, the corporation underreported its net income for the years 1998 to 2002. Its actual net income for these years was more than \$1.8 million and not the \$169,706 reported on its corporate income tax returns. The underreporting of income is part of the \$6.5 billion tax gap California faces each year. The tax gap is defined as the difference between the tax that is owed and the tax that is paid.

The corporation failed to report more than \$18 million in wages paid from 1998 to 2002. To evade the requirement to withhold state income tax, Stanley maintained two sets of corporate payroll registers for each year involved in the investigation. Employees were paid with two checks. One paycheck was calculated at the minimum wage with taxes properly withheld. Employees then received a second check paid out of the company's general fund and labeled "exempt earnings." No taxes were withheld from these second payments.

The company also misclassified the majority of the employees as office workers and not as drivers. This resulted in a lower workers' compensation premium.

Stanley's sentencing and restitution determination are set for November 14, 2008. The total amount of restitution payable to the state will also be determined at that time.

This was a joint investigation between the Orange County District Attorney's Office, the Employment Development Department, and FTB.

---